

ADDRESS

Federal Valuation of the Railways
to the
Trust Company Section
The American Bankers
Association

by

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I went to Philadelphia not long ago on a purely social errand, to have a good time, and while there Mr. Mason demanded that I appear before you this evening. So the crime is his and not mine.

I really did not know what to talk to you about until it occurred to me that you might be interested in a feature of the working out of the transportation business which is now going on and which is known as the Federal valuation of the railways. The duty of imposing that valuation is upon the Interstate Commerce Commission and upon the railways, and it is a very large task.

The Valuation Act. The law which was passed early in 1913 says, among other things:

“That the Commission shall, as hereinafter provided, investigate, ascertain and report the value of all the property owned or used by every common carrier subject to the provisions of this Act.”

And also that the Commission:

“shall ascertain and report in detail as to each piece of property owned or used by said common carrier, the original cost to date, the cost of reproduction new, the cost of reproduction less depreciation, and an analysis of the methods by which these several costs are obtained, and the reason for their differences, if any. The Commission shall ascertain and report separately other values, and elements of value, of the property and an analysis of the methods of valuation employed.”

All this involves a very difficult and heavy task, and to do it the Interstate Commerce Commission created a valuation division with the Hon. Charles A. Prouty as director, who divided the country into five districts, Western, Eastern, Southern, Central and Pacific. An engi-

neering board of five was appointed for each district and under them are employed large forces of men.

The Railways Co-operate The railways, for their part, organized by creating a Presidents' Conference Committee, with Mr. Samuel Rea as the General Chairman and Mr. Thomas W. Hulme, of the Pennsylvania Railroad, as the General Secretary. The railways were divided into three groups, Eastern, Western and Southern; and an engineering committee was appointed from each of these groups—a committee on land and also on accounting, and all three committees work together with the Government in the effort to bring about the desired results with a minimum of friction and delay. In addition, each railway has its own organization made up in the main of a valuation committee, consisting of an experienced engineer, accountant, and either a real estate man or a lawyer, and under them a large number of men are employed to do the great amount of detail work necessary. For example, on the New Haven road there are 138 men employed at the present time exclusively on this work, and in addition, a large number of other officers and employees in all departments take part in the work.

The Cost? Now, all this work is to cost a great deal of money. I use the New Haven for example because I happen to have the accurate figures, and for that road alone the valuation work will cost between \$500,000 and \$600,000. Various estimates of doing the work have been made as to the total cost to the railways in the United States. These estimates, when the law was first discussed, were quite low, only \$10 or \$15 a mile, but it was quickly seen these figures were entirely too low and that the cost would run very much higher, probably from \$150 to \$200 a mile, or a total of thirty-five millions to fifty millions of dollars to the railways alone. And the estimated cost to the Government has been raised from time to time so that now no one

really knows what it is to cost the Government, but the last estimate was in the neighborhood of fifteen millions of dollars. Thus, the total cost to the railways and to the Government, and, of course, indirectly, to the people of the country, will be anywhere from forty millions to seventy-five millions of dollars. Now, this is such a large sum that the question may well be asked, "Why does the country engage in this work, and could not the same amount of money have been spent to better advantage for the countless improvements needed on the railways?"

The Time? It will take a long time to do this work; Mr. Prouty has estimated that it will take at least four years from January 1 last to complete the inventory, and a great many of us think it cannot be done within that time.

The Purpose of The Act? The law itself does not give the reasons for making the valuation, so each person must come to his own conclusion. Some say the purpose of the valuation is to produce a more rational basis for the fixing of rates; others that it is made for the purpose of adjusting taxes; others that it is for the purpose of making a figure at which the Government can take over the railways; and still others, that the establishment of the valuation will form a sound basis for credit and be a step forward in settling the very complex transportation problem of the country.

Many of us, in the railways and out of the railways, I think, are ready to admit that in the great creative work of producing the 250,000 miles of railway in the United States some mistakes were made in financing and in methods of management, but railway owners and managers have learned a great deal in the last twenty years, and so have railway regulators. We must also admit that at times the men on the railways who made the rates and adjusted the differentials had very extensive unregulated powers and in many instances they exercised those powers unwisely, with the result that finally the Interstate Commerce Law with power to fix rates was

enacted. But the spending of huge sums of money for the valuation of these railways, because of the supposed effect of the valuation on making rates, does not seem necessary because rates are the result of countless forces and valuation is not, in many cases, one of the controlling forces.

Chairman Martin A. Knapp, away back in 1899, gave important testimony on this subject. He said:

“I have not seen any instances in which the rates have seemed to much depend upon or be influenced by the capitalization of the road.” Q. “You have never seen such a case?” A. “I have not. The capitalization of the railroad I think cuts no figure in the rate question.”

While the valuation of the railways has very little relation to the making of any particular rate, the courts have held to the opinion that rates, as a whole, “in force upon a railway could not be lowered below a point sufficient to yield a fair return upon the property,” but the courts have almost as consistently refused to make any hard and fast rule as to how that valuation was to be determined and have decided each case on its merits.

Justice to Investors. As a result of the constant and very natural discussion of the conduct of the railway business of the United States, and especially of this valuation problem, there have recently developed two schools of thought in the country. One school says, and, I think, with justice, that the country, having encouraged private individuals to invest their funds in public utilities, and having imposed upon those investors all the risk of loss, should give to them any rewards of success in management or of good fortune in investment and allow them to have some return upon the increased value of their investments, even if the growth of population of the country, in which the public utility was an important factor, has produced that increase in

value. This seems, to most people, a simple act of justice, and a reversal of this policy without proper compensation to the millions who have put their money into the enterprises would seem to violate the Fifth and Fourteenth Amendments of the United States Constitution. In making this statement, I do not defend any of the unwise things that may have been done by some in promoting, constructing and operating public utilities nor do I say that people must be guaranteed against loss. Errors have been made from which stockholders and the public alike are suffering, and stockholders in wisely conceived and well-managed public utility corporations are suffering because of the sins of omission and commission of unwise men who were in the business.

Problem This problem of valuation is a very, very
Important and difficult one, and of more importance to the
Difficult. country than one realizes unless one thinks it over very carefully. It has been estimated that the properties of the railways and public utilities under the jurisdiction of the various commissions, Federal and State, are worth about thirty billions of dollars, or one-fifth of the national wealth. If those who are to make this valuation are unfair, or swayed by personal or political motives and make errors, confidence and credit will be shaken and undermined. The valuation should be fair and take into account all of the conditions. If the valuation is too high, an injustice will be done to the public; and if it is too low, an injustice will be done to the owners of the property. The Constitution and the decisions of the courts up to the present time must be considered in arriving at the valuation of the railways.

The Supreme The Supreme Court has said:
Court Says. "The equal protection of the laws—the spirit of common justice—forbids that one class should, by law, be compelled to suffer loss that others may make gain. If the state were to

seek to acquire title to these roads under its power of eminent domain, is there any doubt that constitutional provisions would require the payment to the corporation of just compensation, that compensation being the value of the property as it stood in the markets of the world and not as prescribed by the legislature? Is it any less a departure from the obligations of justice to seek to take, not the title but the use for the public benefit at less than its market value?"

And the Supreme Court of the State of Washington, in a tax case, declared recently that there are intangible elements of value in a railway property, such as density of traffic, convenience of fuel supply, proximity to markets, and so forth—in other words, the value of the business as a going concern.

Senator La Follette, who cannot be called a champion of the railways, made a three days speech in the Senate in 1906, and he admitted that to the appraised value of the tangible assets of a railway, the value of franchises and of the property as a "going concern" should be added to determine value for taxation or in a commercial sense, but urged that there was a broad distinction between valuation for taxation and for rate making in that there was no element of an investment in "going concern" value.

This does not seem to be fair, because there certainly is an element of investment in "going concern" value, for, until an established business is acquired, capital earns nothing. Few industries, if any, especially railways, are self-sustaining from the first day of their operation; and it is well known that at the beginning many of the great railway systems were financial failures. Newly constructed mileage in undeveloped territories show that the railway builder must look to the future for his reward. Is it fair to say that a long history of careful, prudent management does not bring to a concern, railway or not, some element of value which should be

considered in arriving at the fair value? What decision will be finally made concerning this matter by the Interstate Commerce Commission or by the Supreme Court no one, of course, can say. But upon these decisions will depend very largely the future of the railway business of the United States.

Trying to Value Harvard. Mr. Frederick W. Whitridge, of the Third Avenue Railway Company, in a paper entitled, "Official Valuations," read before the American Economic Association, told this story:

"Some years ago a very rich man who proposed to found a great institution of learning in one of the far western cities, went to Cambridge to see what was being done at Harvard. He passed a day or two in looking at its buildings, libraries and museums, and inquiring into the courses of study and the work carried on. At the end of that time he turned to those who were showing him about and said, 'Well, gentlemen, what is your whole plant worth?' They looked blank, and the millionaire repeated, 'What is the value of it? How much did it all cost?'

"The notion that Harvard University, the product of two centuries of the time and lives and labors of thousands of good men, could be valued in money was strange; but the millionaire was insistent upon an answer, and one official replied:

" 'I suppose it cost perhaps so-and-so many millions,' and the plutocrat turned to his wife, who happened to be with him, and said:

" 'Well, mother, I guess we can do better than that,' and went away quite confident that it was within his power by the mere expenditure of money to at once produce an institution more valuable than Harvard University."

It would be well worth while to keep this story in mind when considering this great problem of good will in arriving at a valuation of public utilities.

**Divergent
Views.**

Another school of thought in this country says that no return should be made except upon original cost. Among the champions of this idea are found members of commissions and of political bodies and a number of theorists who believe that everything should be done to force the lowest possible rates, paying not enough attention to the fact that service from the railways is even more necessary than the lowest rates. And some of these thinkers say that the public should not be expected to pay a return upon any more capital than was originally invested in a prudent manner; but is this the whole story, and who is to decide to-day what was prudent ten, fifteen, twenty, even seventy-five years ago? Must not the country, as long as it sticks to the theory of private ownership of public utilities, allow those private owners to make their investments with the hope of a profit, inasmuch as they assume the burdens that come with increased complications due to increased values in all other properties and the complications of modern life? If they take all the risk of loss, they are surely entitled to some of the benefits of gain. Those who take the position that they are not entitled to this ought to remember that the people, in exercising their great power through the Government to regulate and, at times, to punish the railways for errors and failures, may go too far and hurt those who are not responsible in any way for the errors and weaken the effectiveness of the very institutions that must be well equipped to serve the public. Railway property, after all, is still private property, and no power on earth can justly require the use of that property without a reasonable reward.

Chief Justice Waite settled that principle when he said:

“This power to regulate rates is not a power to destroy, and limitation is not equivalent to confiscation under pretense of regulating fares and rates. The State cannot require a railroad corporation to

carry persons or property without reward. Neither can it do that which in law amounts to taking of private property, either to be used without just compensation or without due process of law."

So that if men have had the courage and ability and foresight to invest in a railway or a public service business which happens to turn out to be profitable, it certainly is not fair to these men, later on, to transfer that profit to others by means of legislative act. The country might, and no doubt can, say what the future policy will be, but it surely should not take an unfair position about investments made in the past.

Real Estate Valuation. If we take the original cost of real estate as a basis for the present valuation of the properties, then, as I say, we ought to take all of the original conditions surrounding the operation, and that is manifestly impossible. In condemnation cases, railways must pay value, and generally high value, instead of original cost, and the taxes and other burdens are not based on original cost but on present value. In the same way, charges or rates must be based on all elements of value and not simply on cost.

Great merchants realize the importance of good and permanent locations in their business. The beautiful Altman building, in New York, occupies about two acres. The original cost of that land is not the basis of the overhead charges which must be taken into account in carrying on the dry-goods business then, but the fair value of the property to-day. Some of that land is said to have changed hands at prices as high as \$250 a square foot, and other parcels at \$100. At an average price of \$100 a square foot, the Altman block represents a value of eight and a half millions of dollars, and a business is supported on that expensive piece of property. Now, this value comes from its location and its readiness to furnish a service that the public want. And in the same way the great terminals of the railways in the cities of the country

have a value because of their location and their ability to serve the people. It has taken many years to assemble those great terminals and to have them ready for public use. But sometimes railways are blamed for obtaining additional facilities before they are actually needed, and yet railways must look ahead and try to get those facilities and carry them until they are needed. Is there any reason why railways should not be allowed to put those properties in at a fair valuation in figuring up their assets and liabilities? This raises one of the great questions about which there will be much discussion before the Federal valuation work is finished.

It seems to me that the proper economic and legal view should be that a public service corporation may consider the increase in value of its real estate as part of the value upon which it is entitled to a reasonable return, for the corporation is entitled to a fair return upon the value of its property "at the time it is being used for the public," and "if the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase."

It is possible to conceive that, after this valuation has been completed and settled, the country then may serve notice upon investors and others, that thereafter they will not be allowed any increment, and that would be giving due warning to the public as to the conditions under which they should invest in railway property, but to take that position now would seem to be a gross act of injustice. Some say that those who take this view of the value of lands desire as low a valuation as possible so that the Government can acquire the railways at a minimum price.

Rate Making. If the valuation is for the purpose of rate making, it would seem as if the country is amply protected as to its rates because the powers of the Interstate Commerce Commission are very extensive, and by the further fact that great commercial forces really

have more effect in the making of rates than the amount of value in the property used or of capital that may have been invested therein. If it were not so, every railway would adjust its rates so as to get a return upon its value or investment and we all know this is absolutely impossible. While the valuation will have a bearing on the general situation, it cannot be entirely determining, and the power of the Commission to protect the public is very great. And it is a question in connection with this rate making whether the power of the Commission should not be changed somewhat to protect the railways and authorize the Commission to say not only what the maximum rates shall be but also to say what the minimum rates shall be and to say what the relation of rates, or the differentials, shall be so as to prevent too wide fluctuations and disturbances in the general rate structure. A reasonable rate is a very difficult thing to arrive at or to describe, but it certainly seems as if the Interstate Commerce Commission, or any other body which is to finally pass upon rates, should be required in ascertaining and determining what is a reasonable rate for any service, to take into account and to duly consider the value of the service, the rights of the passengers, the rights of the shippers and the owners of freight, and all expenses incident to the maintenance of the property and its operation, the rights and interests of the stockholders and creditors and the necessity for the maintenance by the railways of efficient means of transportation and margin enough so that they can establish at all times better facilities and improved service, and at times there are other considerations that come into play.

Smyth vs. Ames Decision. No authoritative legal statement whatever as to the method of determining the valuation of a railway was made until 1898, when, in the decision of the famous case of Smyth versus Ames, the Court said, in a statement that has been quoted very often and which is rather the basis of the present valuation act, as follows:

“We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present, as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth.”

Initial Cost. To arrive at the initial cost of these railways will be very difficult. Take the Baltimore & Ohio Railroad, for example, which has over one hundred separate corporations. The Pennsylvania has as many. The New Haven has over a hundred and seventy-one. It is almost impossible to obtain complete and satisfactory evidence as to the original cost of these railways. Original cost in many ways was probably very much greater than the cost to-day because of our improved methods and appliances. Many can remember when steel rails had to be brought from Europe at prices far in excess of those now paid.

Not long ago, in discussing this subject with officers of the Federal Government, they said they were not so sure but that the original cost of many railways, leaving out the one question of real estate, would

not be higher than the fair value on a reproduction basis. And it would seem as if it was the present value which must be obtained and the initial cost is relevant only as having a bearing on that value, for it has been held that where the property of a public service corporation has appreciated in value, it is the present value which must be considered for the rate making and not the cost.

It was pointed out in the Minnesota decision:

“No guaranty was ever given by the state to the old road that the price of materials and the cost of construction would not decline, or that capital invested in railroads should not be subject to like vicissitudes as capital invested in other enterprises. Modern improvements and other causes have continued to reduce the cost of construction of all kinds of new plants, and to reduce the value of old plants, or render them wholly worthless, and the state did not guarantee that those causes should not in like manner affect the capital invested in railroads.”

In other words, the investor had to take the risk.

**Cost of
Reproduction
New.**

Cost of reproduction new has been generally accepted as one of the most important elements entering into valuations, and a number of states have made valuations for various purposes on that basis. The “cost of reproduction,” however, presents opportunities for contested opinion because of the different views of engineers, involving questions of intangible value, contingencies, interest during construction and discount on securities. All who have had experience in the construction of large works know that the unexpected often happens and that contingencies and unusual items enter into cost generally to a greater extent than was expected.

The large transactions of modern business and the great work of the railways must be done very largely upon borrowed money, and, therefore, the problem of the

proper valuation of the railways not only as a support for bonds heretofore issued but also for stock subscribed for by the public and for obtaining new money is of vital importance. In order to get the 250,000 miles of railway now in the United States constructed, it was necessary, at times, to offer bonuses of stock with bonds, and to sell bonds at a heavy discount. These items of interest and discount are fair items to be considered in arriving at a fair valuation of the properties, and this is another of the important questions that must be decided by the Commerce Commission, and later, perhaps, by the courts.

Justice In Justice Harlan's decision in *Smyth vs.*
Harlan's Ames he discussed the amount and market
Decision. value of stocks and bonds, but this is not mentioned in the valuation act. The market value of stock, of course, depends somewhat upon the underlying security, but is due more to the return, which depends upon rates charged in the past, and upon management, and the market value of the stock could not logically be considered in fixing value. Prices may rise or fall from causes which have little or nothing to do with the real value of the property. Moreover, the orders of a railway commission as to rates may cause a change in earnings and a depreciation in value. And surely a state ought not, through the orders of a commission, reduce rates, tending to depreciate the market value of securities, and then set up the claim that this low market value must be taken as a fair test of the value of the property.

President Hadley, in the report of the Railway Securities Commission, said:

"In so far as the value of the property is an element in rate regulation the outstanding securities are of so little evidentiary weight that it would probably be of distinct advantage if courts and commissions would disregard them entirely, except as a part of the financial history of the property, and would insist upon direct evidence of the actual money invested and of the present value of the properties."

So we may again ask: "Are the railways to be valued for rate making upon a different basis than for taxation or commercial usage?"

Market Value. The market value of a well equipped, well organized railway, a well developed business, is likely to be far in excess of the mere replacement cost of its tangible assets. Assume, for example, that at a cost of \$50,000 per mile a road has been built to serve various mines and later they are practically stripped of ore and the road has little to do. Nearby there is a road on the prairie built for \$20,000 per mile, which has a permanent source of freight. Will cost of reproduction be considered in ascertaining which of the two is more valuable?

Under the present difficult conditions confronting the American railways, it would seem that the faith of the railway bondholder and stockholder must be pinned to the Interstate Commerce Commission, and that the valuation cannot be completed too soon for the investing public, and for the benefit of the users of the railways, who must have additional facilities.

"Water." A great deal has been said about the "water" contained in American railway securities, and this valuation will, it is hoped, dispel some of the doubt surrounding this important matter. Whatever inflation there may have been in some of these properties, the fact remains that present capitalization, as a whole, is much lower than that of the Government owned railways of Europe, and, what is still more important, the rates charged are the lowest, the service rendered, on the whole, the best, and the wages paid the highest. The charge of "watered stock" can only be made against a limited number of our railways. A very large number of them have been managed well and without scandal or criticism.

Whether or not there was a general public demand for this valuation work is not now the question. The

law is here and must be obeyed, and it is to the interest of the railway owners to have the valuation made as rapidly as possible, and railway managers as a whole are heartily and earnestly co-operating with Director Prouty and his large organization in bringing about the desired result. Many of us in the railway service believe that when the final result of this valuation work is obtained and settled by the Interstate Commerce Commission or by the courts, it will show that American railways generally are worth more than the par value of their securities and that the constant charge of over-capitalization will be refuted and one unfortunate element in the settlement of our transportation problems will be eliminated.

Peace, Health and Prosperity. The foundation of the peace, health, comfort and prosperity of the nation may be represented by the first four letters of the alphabet: "A" for agriculture; "B" for banking; "C" for carriers; and "D" for digging, or the mining industry.

The country generally agrees that we must support, encourage and develop agriculture in every possible way in order to feed our growing population. The country, also, generally agrees that banks and bankers are necessary and that they must be encouraged. The country, furthermore, generally agrees that the mining industry must be protected and promoted so that we can have fuel for heat and power and metals for the manifold machines used in our business. The country encourages those engaged in agriculture, banking and mining and does not condemn those pursuits because of the failure of some engaged in them. The country believes that it must have good carriers, or railways, and yet there has been a pronounced spirit of condemning the business because of errors. All four of these great pursuits must succeed if the country is to grow and develop its manifold activities, and they form the A, B, C, and D of the Alphabet of Progress in this country.

The officers of banks and of trust companies represent, according to the last census, more than a hundred and seventy-five thousand individuals, and they and every employee can every day do something to instruct and help the many who come to the bank or the trust company and point out to them how and what is necessary to secure right regulation and the proper solution of some of these complicated questions affecting public utilities.

Standing as I do in the shadow of, and shocked and saddened by a tragedy on the railway of which I am one of thirty-six thousand men, striving under very difficult conditions to furnish adequate and safe transportation to millions of people, I may be unduly impressed with the seriousness of the problems and the great responsibility that rests at the present time upon the railway owner, officer, employee, the Government itself, and the public, to do all within their power to solve quickly the problem of handling these great properties to the best interests of all so they will be adequate to the needs of the country and be in a state of preparedness, come what may.

All Can Help. You, in your business, can tell something to the people about three of the important problems that confront the proper development and management of the business of the carriers. One is that of this valuation upon which will so largely depend the credit of the carriers and their ability to go on with constructive work. Another is that of the wise and proper relation of Governmental regulation, a question that it is hoped will be worked out without forcing upon the country Governmental ownership before our political methods and machinery are ready. Another is the proper solution of the relation of the great army of employees to the public and the railways. If the railways are to be controlled by the Interstate Commerce Commission and State commissions as to rates and the service they give in the interest of all the people, then it would seem as if some way should be found to control reasonably the

great army of men who help to produce that service. If there is to be an Interstate Commerce Commission to adjust disputes about rates, it may be there should be an Interstate Wage Commission to adjust disputes about wages. These are all very important problems which should be solved very quickly if we are to be ready for the volume of business now upon us, and that we all hope will continue. These problems cannot be solved by neglecting them and permitting the public to get facts from those who, sometimes, do not always consider how far selfish interest, and, to a certain extent, prejudices, may lead them astray. This is a time for everyone to try to do what he can every hour of the day to develop a sound public opinion that will help protect the present and the future of the country.